RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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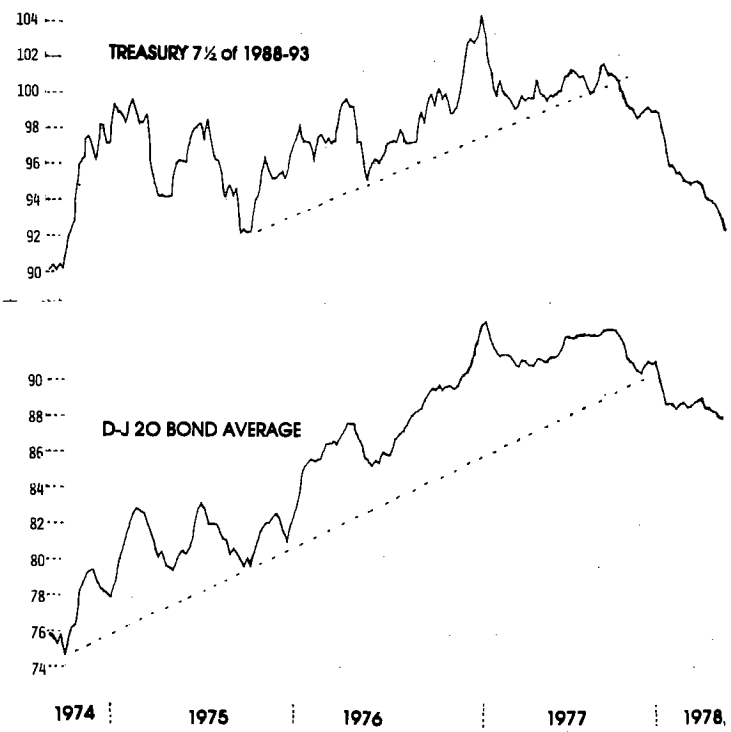
May 17, 1978 **LETTER 731**

May 5, DJIA 829.09; PTI 749; A-D ratio –18.39
May 12, DJIA 840.70; PTI 803; A-D ratio –17.85

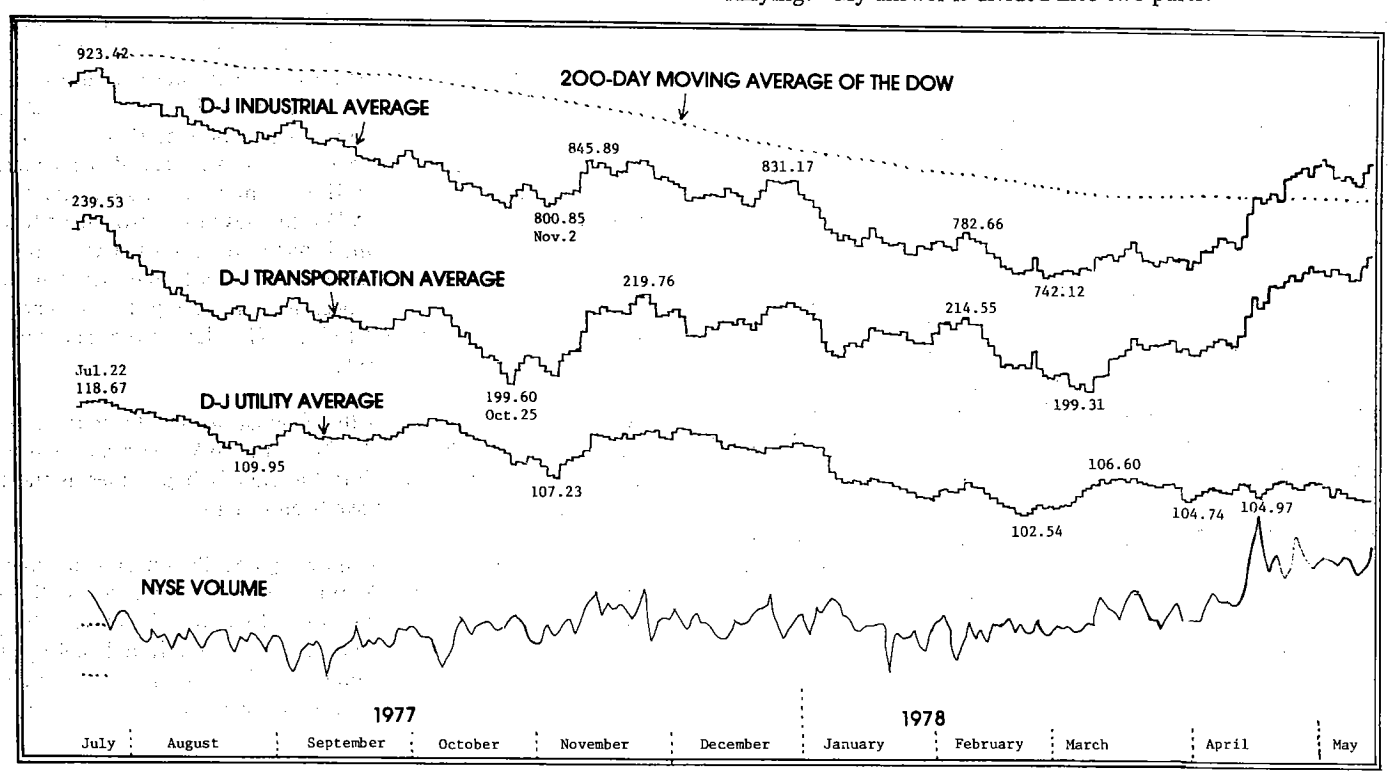
THE PICTURE: On May 11 the Fed raised the discount rate for the fourth time in recent months, this time to 7%. A few hours later it was announced that the M-1 money supply had surged $4 billion for the week, a rate of 14% increase over the past few weeks. Thus, with inflation heating up to double-digit status again, it is clear that the monetary situation (like the Federal debt) is careening "out-of-control."

But the bond chart on this page has been telling us that story all along. And to my mind it is the crucial story in the financial markets today. In brief, the bond market is caving in. Last week we saw lows in the Municipal Bond Average, in the Treasury Bond Average and in the D-J 20-Bond Average. Furthermore (see bottom chart), the D-J Utility Average last week closed below its early-April low of 104.74, thus tracing out a decisive downward zig-zag. The trend of both Bonds and Utilities is therefore classified as down.

As illustrated in the last Letter, when the trend of both Bonds and Utilities is down the background for the stock market turns negative. In fact, I know of no case where the market mounted any kind of major advance in the face of a bear trend in both Bonds and Utilities. One of the reasons for this is that Bonds and Utilities constitute an excellent gauge of the trend of money. A second reason is that when the bond markets go down, we are watching a market valued in the trillions of dollars in the process of liquidation. The bond markets dwarf the stock markets in size and value, and already the mounting bond losses are astronomical.



"OK, Russell, " you retort, "but if the bond markets and the Utilities are negative, then how is it that the stock market is rallying?" My answer is divided into two parts:



(1) The market can do *anything* over the short term. Time-honored stock market relationships, technical indicators, barometers, all of them can get "out-of-whack" over the short term. But over the longer term the market tends to do what "it is supposed to do," to act rationally and logically.

(2) There is a new ingredient that has been added to this market. The new element is the elation and near-hysteria that has accompanied the strengthening dollar. And, of course, the other side of that coin is **foreign buying** of stocks. If you are a German or a Swissman or any hard-currency foreigner, you've been watching US stocks sink out of sight on the downside in terms of your own strong currency. And you've been waiting patiently for the dollar to turn stronger so you could buy those American stocks at "fire sale" bargain prices. Then, when the dollar turned stronger, the explosion occurred. In buying American stocks (as a foreigner) you envision a double profit, a profit on a rising stock market and a profit on a rising dollar invested in US stocks.

So we have the unusual (and I believe temporary) situation of higher US interest rates working to strengthen the dollar. And the dollar's rise has, in turn, brought in heavy foreign buying of US stocks.

This heavy foreign buying has temporarily counter-balanced the normal tendency of the stock market to decline as interest rates rise, as new borrowed reserves of the banks expand, as the bank credit figures in general turn negative.

On top of the extraordinary foreign buying the current gambling mania in the US has provided a frothy character to the stock market, a psychology of "Grab 'em before they go out of sight on the upside." Add to this a Dow that had been sliding for 17 months without an important rally, and you have the background for the current move.

I have been doing a few interesting calculations. On April 13 volume on the NYSE jumped above 30 million shares for the first time on this advance and it has stayed above 30 million shares ever since. In fact, average daily volume since April 13 has been 37 million shares. On April 13 the Dow was 775. Based on the current Dow price, it has taken more than 15 million shares to lift the Dow **each point of its rise** since April 13. That's an unbelievable amount of steam to move the market engine.

The average price for the Dow since April 13 (figuring all the Dow closings since then and dividing by the number of days) is 823. I consider this 823 figure to be very important. For it means that the greatest volume explosion in market history produced an average Dow price of 823. It is my feeling that if the Dow holds above 823 the fireworks can continue. But if the Dow drops decisively below 823 the market will be locking in hundreds of millions of shares at higher prices. So let's see how it all works out.

THE SEND_OFF: I have discussed this phenomenon with a number of analysts, and the May 5 issue of the *Wall Street Advisor* (PO Box 2591, Ormond Beach, Fla. 32074) also goes into it. It's the strange absence of the "send-off" figures on the advance which began on February 28.

What I am referring to is the fact that every important and lasting advance in modern history was inaugurated by at least three (usually many more) upside breadth figures of .50 or higher. To obtain these figures, simply subtract the daily declines from advances and divide the resultant figure by the total issues traded on that day.

For instance, the 1949 bottom produced a plus .49, a plus .51 and three figures over plus .42 within two months (June and July) of the bottom. The 1953 rise produced three figures of better than plus .50 within a month of the bottom. The 1957 bottom produced plus figures of .68, .71, .50, .56. At the 1972 low we saw a plus .65, .54, .65 and later a .64 and a .48. At the 1970 lows (March to June) we saw a plus .70, .60, .51 and .45.

At the 1974 lows (October) we had a plus .59, .53, .58. Three months later in January, 1974 we had a plus .72. .52, .42, .53.

At the recent lows the breadth figures were surprisingly lacking. Disguised in the record-breaking volume was the fact that there were only 2 days of upside breadth which displayed any strength and even these were **sub-standard** days which did not compare with the "send-off" blasts of previous true bottoms. What were the figures on the latest advance? On March 10 we had a plus .45. On April 14 (it took another month) we had a plus .46. Send-off figures of that kind never set off a lasting advance before.

The explanation for the low breadth ratios is that there has also been heavy selling during the whole period, selling which has pushed up the daily decline figures above the 400 to 500 level almost every day. This phenomenon has prevented the big upside figures on the A-D ratio from developing.

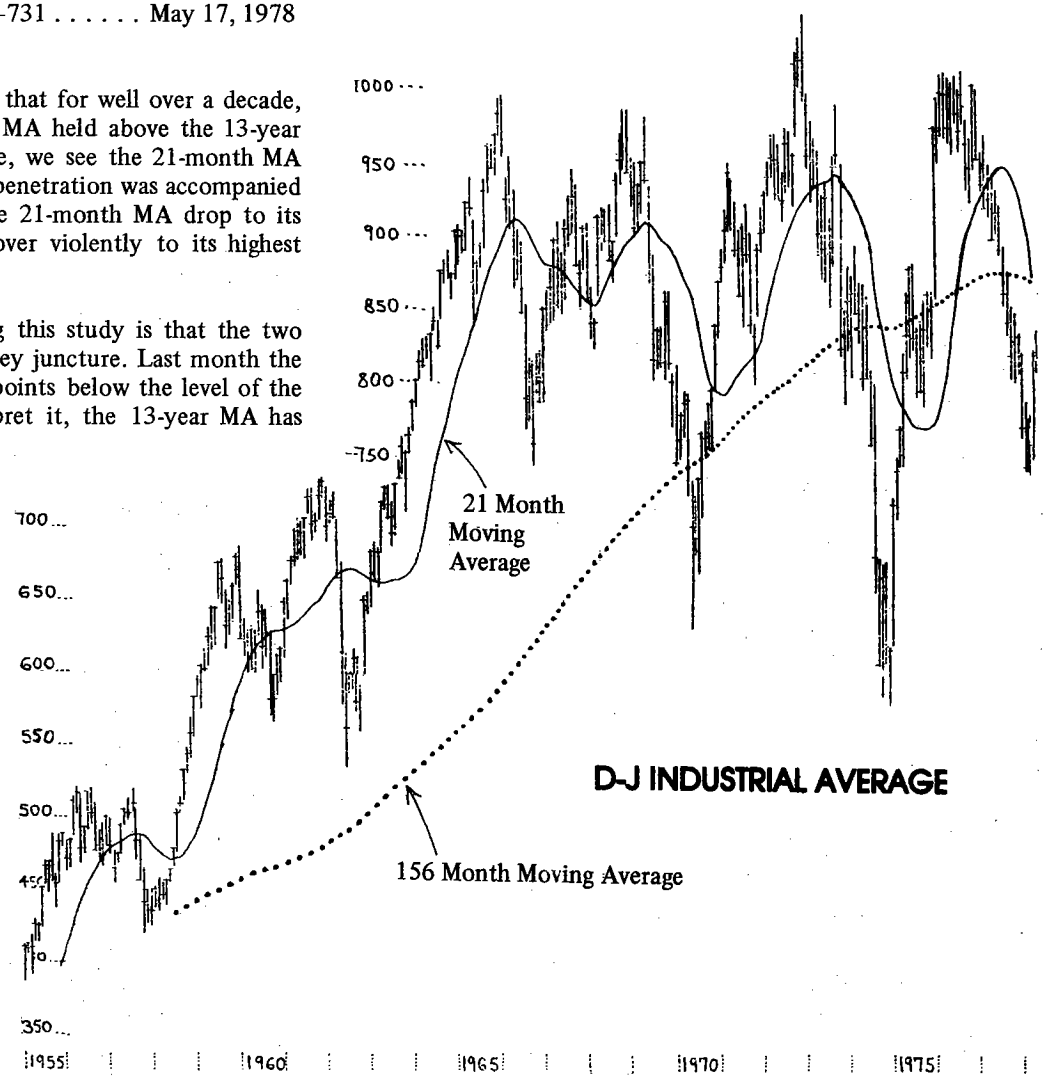
MOVING AVERAGES: In Letter 727 I included a piece about the "very long term" moving averages of the Dow, specifically the 13 and 55 month MA's. Since I have been doing a good deal of work with these long term MA's, I thought readers would be interested in a second piece on the longest-term MA I use. On page 3 we see the 156 month (13 year) MA. I use 13 because it is a Fibonacci number and because many interesting events have occurred in the 13 year intervals. For instance, the year 1903 saw a low in the D-J Industrials (at 42.15) that was not violated (and only then for a single day) until 1932. The low of 42.15 was never broken again. Thirteen years later, in 1916, the Averages recorded a major bull market top. In 1929 (thirteen years later) a great bull market recorded its high. In 1942 the post World War II bear market recorded its famous low of 92.92. In 1955 the A-D ratio was in the process of forming a top (reached in 1956) which has never been bettered. In 1968 we saw a surge in speculative sentiment that has only been duplicated on two other occasions in the past 40 years (the two times were 1945 and today). That leaves the next juncture for the 13 year cycle at 1981.

At any rate, I have shown the 13-year MA on the chart, together with the 21 month MA. The 21 month MA covers a cycle-span of a little under two years, but the signals it provides as the Dow crosses above or below it have been valuable.

The 13-year MA has been moving steadily up almost from the inception of the 1949-66 bull market. Even through the bear market (which began in 1966) the 13-year MA kept climbing. In 1974, for the first time, the 13-year MA faltered slightly, then pushed higher–to a December, 1977 peak of 875. From there the 13-year MA has finally turned down. As of the end of April, this MA was down to 871.

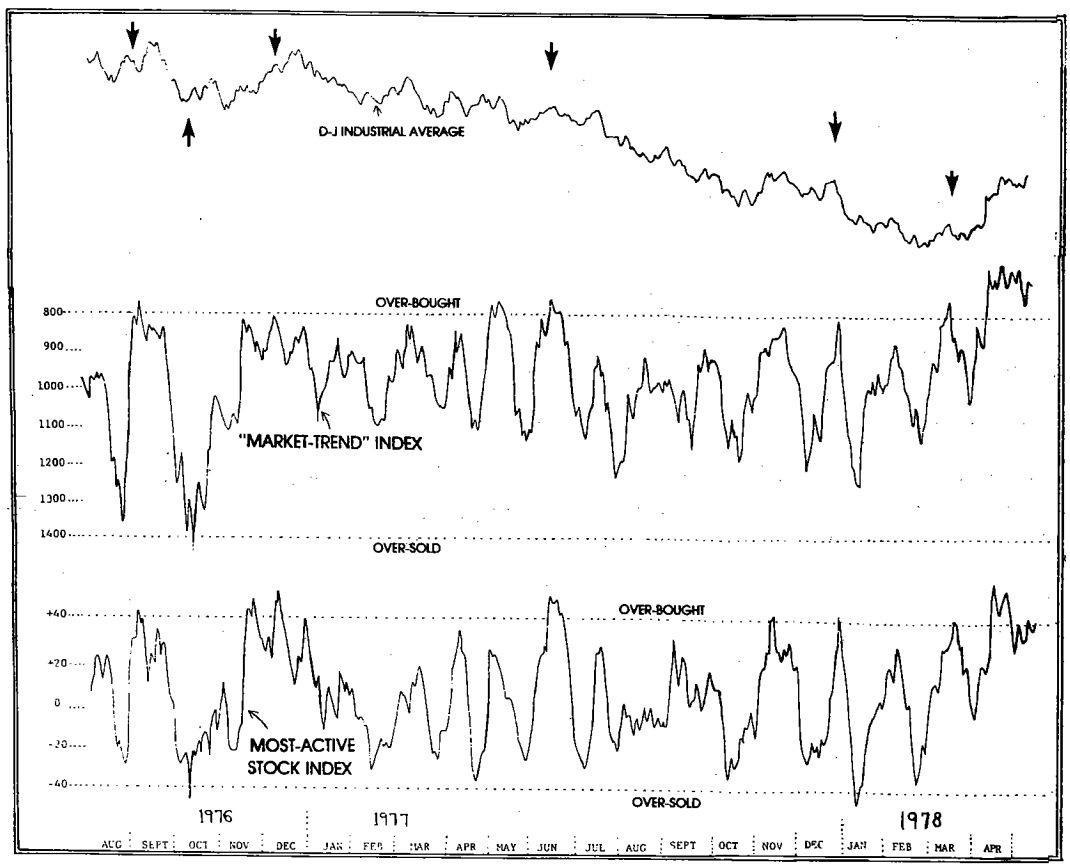
Meanwhile, it is interesting to note that for well over a decade, despite all reactions, the 21-month MA held above the 13-year MA. But in 1974, for the first time, we see the 21-month MA plunge below the 13-year MA. This penetration was accompanied by the 1974 crash. We also see the 21-month MA drop to its lowest level in 10 years, then recover violently to its highest level.

One of the reasons I am including this study is that the two MA's are now at what could be a key juncture. Last month the 21-month MA dropped to 869, 2 points below the level of the 13-year MA. Therefore, as I interpret it, the 13-year MA has formed a massive technical "roof" over the market, and, the 21-month MA is descending through the roof. Furthermore, all rallies and declines in the Dow are now occurring at price levels below that of 13 years ago (incredible), and thus, by construction, the 13-month MA is slowly coming down.



Here's another way of looking at the picture. Over the past 13 years investors have been willing to pay an average price of 871 for the Dow. Over the past 21 months investors have been willing to pay an average price of 869 for the Dow. Now the average price investors have been willing to pay (over a 21 month period) is about to decline to a lower figure than the average for the past 13 years. Thus, something is fundamentally changing—and the change is clearly negative.

"MARKET TREND INDEX": I have had many subscribers ask me about the **market trend indicator** that I use on the over-bought and over-sold study. This indicator is the ratio of advances over declines divided by the ratio of upside volume over downside volume. The index works this way. Say there are 600 advances and 300 declines and volume is running 6 million up and 3 million down. Thus we would have a ratio of 2. (600 divided by 300) and this divided by a ratio of 2. (6 divided by 3) to give an index reading of 1.00.



Now suppose with the same 600 advances and 300 declines we have 8 million in volume on the upside and only 2 million shares of volume on the downside. We then have a ratio of 2. divided by a ratio of 4 for an index figure of .5. Now since it is taking much more volume on the upside (8 million) to produce the same 600 advances and 300 declines, we have upside "churning," a situation which indicates growing technical weakness.

In other words, the market trend index shows balance when it is at 1, but as it moves lower it shows a condition of upside churning (more and more volume to do less and less on the upside). Conversely, in a decline when the index figures move higher, we have a condition where it is taking more and more volume to produce less and less decline (this is churning on the downside, and it implies a market that is becoming exhausted and nearing a bottom).

The lower chart on page 3, which has appeared repeatedly in these reports, shows what has been happening on this advance. The market trend index has shot into the rarefied "above 800" level, and it has stayed there for 21 days. Frankly, I have nothing to compare this with in the way of previous over-bought markets. I've never seen the over-bought index stay so high so long!

The market trend index is confirmed by an over-bought situation on the most-active stock oscillator (8-day moving average of daily differential figures). When people have asked me why I don't buy some stocks in this area, I look at these indicators and say, "If I bought them today (or two weeks ago) and the market started down, I wouldn't have the guts to hold 'em a day. When you feel that way, and it's based on evidence, not emotions, you just have to skip the move."

NOTES FROM THE UNDERGROUND: Of all forms of human "endeavor," I believe the highest is listening and acting on one's intuition. This is the "voice within you" and many sage observers have opined that your intuition is really your connection with the universal power or God. I firmly believe that. I have had, in my lifetime, many flashes of intuition (some people prefer to call them "insights") which have been beyond any mental capabilities I normally possess.

On a number of occasions (and I mean a number) my intuition saved my life. On other occasions, my inner voice has led me on the correct path when no amount of so-called common sense or analysis would have done the same. Many times I have been drawn to a person as if by some overwhelming force. That magnetic pull, I believe, had to do with my inner voice. And at other times I have been repelled by somebody, suddenly felt as if they were "poisonous," and again my inner voice said "Split, drop them, leave them immediately." In retrospect (and this is by no means a boast), my inner voice has almost always steered me right.

So my message is that I believe we should constantly try to get in touch with our inner voices, that intuitional feeling that can be so right (but which is so easy to ignore if one uses his reasoning rather than his feelings). A great psychiatrist once wrote, "Lose your mind and come to your senses." And of course he meant, stop reasoning everything out and follow your own inner voice. The organism is almost always right, the thinking man is (hopefully) sometimes right.

* *

My wife, Paula, and I had dinner a few nights ago with one of the leading commodity traders in the nation. This gentleman (who possesses an extraordinary record) was saying that he sees many commodities "topping out" and "rolling over," and the overall picture, he feels, is not one of inflation–but deflation. At one point he said, "Do you remember many months ago in one of your Letters you wrote about the possibility of everything, stocks, bonds, commodities, metals, houses, absolutely everything, going down in price. In other words, a great deflation as money becomes scarce, business turns sour and interest rates soar, due to a panic for liquidity. I often think that we are slowly moving into just that situation."

"Yes," I answered, "I believe there are secular (long term) forces now militating towards deflation. The money picture is growing increasingly ominous. If the Fed opts for easier money, inflation promptly leaps to the double-digit level. If the Fed applies the brakes, the stock market and the economy slump and disintermediation at the banks occurs. There's no easy way out at this time. There's just **too little equity** left in the nation and there's **too much debt outstanding**.

"As I see it," I continued, "today's inflation is really a flare-up against the ominous and massive forces of gathering deflation. It's literally necessary to inflate today to hold back deflation. Without inflation the nation would lapse into a deflationary depression, and that's why I say the country is in a position of–inflate or die."

"But what do we do if that's true" asked the commodity man.

"I suppose put everything in cash. But see, that's the old problem again. Will our cash survive? So then we come to the gold hedge, the gold insurance policy of 10% to 20% of assets in the metal. The only item that we know will last if chaos takes over is gold. Gold's value may fluctuate, anything can happen, but it's the best ultimate insurance policy we have."

"I guess so," he answered, "even if you held 80% of your assets in cash and 20% in gold and gold, in a deflationary collapse dropped to $100, you'd be way ahead of the game." I agreed.

* *

(1) The most reliable trend, the one most amenable to detection and the one most reliable for profits, is the long-term trend of the market. Less reliable and more prone to error (our error in identification) is the secondary trend of the market. Less amenable to analysis is the short-term (daily) trend of the market. I would say that at least half the money lost on Wall Street is lost through "gambling" on the daily trend.

(2) Much more is heard about miracle profits garnered through playing the daily and secondary trends than is heard about profits via the primary trend. Yet in my experience the big money is made by those who invest patiently with the primary trend and ride their investments over extended spans of time.

(3) With onerous taxes and the high risk connected with short-to-intermediate term profits, playing the less-than-primary movements has become even less attractive over recent years. Yet inflation and the advent of option trading has increased the average man's desire to "beat the market."

(4) With bonds in the very high yield range, the alternative to attempting to beat the market on every turn becomes an easy one to accept. The alternative is collecting the highest interest rates available since the Civil War.

Eight Cents Was Too Much: The following little piece left a bad taste in my mouth, but I thought it deserved to be read.

> **There are several reasons why the Treasury is opting for a new $1 coin. The $1 Eisenhower coin is too large, too heavy and too expensive. It costs about 8 cents to produce each. The new coin will cost less than 3 cents. It will also last a minimum of 15 years, compared to the $1 bill's average life of 18 months, thus saving many millions.**
>
> **If Congress approves the new coin by mid-1978, the Bureau of the Mint could have them in public hands by mid-1979.**

* *

Note on the letterhead (page 1) that I have changed one item to read, "Minimum of 26 issues a year." I've been turning this report out for 20 years straight without a rest. I'd like to continue to turn it out every 10 days as I've been doing all these years, but it's hard. very hard. It always has been hard, and I am hoping to write this Letter for another 20 years or maybe more. But if I'm going to last, I've got to take it a bit easier; I've got to have a little rest between Letters. I hope my subscribers can understand that.

At any rate, I've decided to gradually switch to a report every two weeks. I believe that the reports will be better and that I'll last longer. I truly hope nobody feels cheated, and if you do, write me and tell me. But I'm doing the best I can, and the only problem is that I can't get enough rest. Therefore, I am going to start somewhere ahead spacing these Letters two weeks apart, mailing them every other Friday. I will also send out an occasional Special Letter in between if I really think one is needed. Anyway, I've been thinking about how I'm going to last into the next century, and (readers willing) this is one way I hope to accomplish it. By the way, in case you've ever wondered, I write all of this report myself. I keep all my charts myself. I've found that when someone else keeps the charts, he does the learning–not me. So it all entails a lot of daily work.

* *

I still have the D-J Averages chart books available at $49 per volume ($52 for Californians). These large volumes have a single page for each year going back to 1885. Charted daily are the D-J Industrials, Transports, Utilities, Bonds and volume with important events labeled on the charts. I consider these albums the most single important "textbook" available on the stock market and urge subscribers to buy one while they are still available. New pages are offered for sale each year.

* *

The new William Simon book, "A Time for Truth." really made an impression on me. One of the things Simon says is that if you want to hang on to freedom, you better start moving yourself and speaking out. And I think Simon's right. Anyway, I've decided to move my own fannie a bit more. I went to San Jose last week where I was taped for Howard Ruff's new national TV program which will be called "Ruff House." Paul Erdman was there, and C. V. Myers was on his way in just as we were leaving. Ruff is an amazing guy, and you'll be hearing a lot more about him.

This morning Jim Blanchard told me that the coming Bahamas Monetary Conference has drawn unbelievable interest and that attendance will be way over the 350 of last year's Bermuda Conference ("many new faces"). For the big October New Orleans Conference Jim's signed up Alan Greenspan and I told him, "Jim, try to get Bill Simon"). He's trying. I'm pretty sure that I'll be there too (if there's anything left of New Orleans after their recent record one-day flood).

* *

I thought the following excerpt from the Chase Manhattan Bank's monthly report was interesting enough to repeat here. As of now, the expansion is 38 months.

> "The National Bureau of Economic Research has measured the many U.S. business cycles that have occurred since 1854. In all that time, only two peacetime periods of economic growth lasted longer than 37 months. One was the initial period of recovery from the depths of the great depression of the 1930s. The other was the period in the early 1960s before the Vietnam War came to dominate the economic scene. In April 1978, the present expansion will be 37 months old. If it continues thereafter – as seems likely – it will thus be in rare company indeed."

LATE THOUGHTS: COMING HOME! For years, while the dollar was going down in value, greenbacks fled the US to the safety of Switzerland, West Germany and more recently Britain (after the pound strengthened) and most recently to Japan. The word from all hard-currency nations was that the US was "exporting its deficit-produced inflation to the rest of the world." And it was true. As expatriated US dollars (billions of them) piled up in Switzerland, Germany, Japan, Britain, the money supply of those nations expanded and the forces of inflation hit these nations hard (much to their consternation).

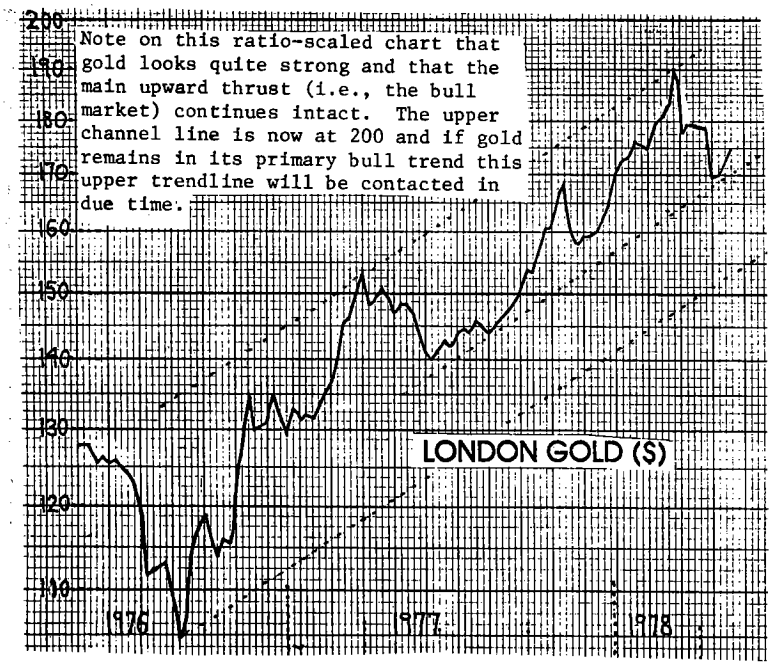
It should be remembered that during this period the US really had an easy time of it. The dollars were leaving the US, and this was actually a non-inflationary (or deflationary) phenomenon. Controlling the US money supply under those conditions was not too difficult a job.

I had been writing for months to the effect that a huge short position had built up against the dollar. Too many people were bearish on the dollar. It was too easy to "predict" that the dollar was going down the drain by the end of 1978. Technically (if for no other reason), the dollar was ready to turn, to rally.

And turn it did. And now the flood is hitting the US, the flood of billions and billions of dollars *coming home again*! Their first landing spot is the stock exchanges. So urgent is the foreign stock buying (particularly British) that currency swaps have been arranged! Listen to this from the May 22 *Business Week: "Of the top 300 US corporations, 50 have entered into one type of currency swap or another; and so great is the demand for dollars from foreign investors eager to plunge into the US stock market, that many other US corporations . . . are negotiating deals."*

Last week the US money supply (M-1) jumped by a shocking $4 billion for the week. Over recent weeks M-1 has been rocketing up at a 14% rate, which is more than double the rate the Fed is aiming at. I'm fascinated to see what the money supply figures are for coming weeks. My bet is that (1) with the dollar turning

stronger, with approximately $500 billions of dollars overseas, the inflation the US has exported for so many years is going to come home–with a vengeance. (2) If so, the US money supply could start ballooning "out of control" at an accelerated rate. (3) If that happens, it will be occurring at a time when the nation is already frightened about inflation. (4) A roaring money supply and its accompanying inflationary pressures would have to be fought. One place it would be fought is on the interest rate front. (5) If so, we could see interest rates literally "run through the roof" as the Fed moves to tighten money. (6) Such action could stop the stock market advance as suddenly as it started and it could also totally collapse the bond market. (7) Gold could have a big run-up if it is seen that the money supply is running out of control. (8) This whole scenario could (if it occurs) present an extraordinary opportunity to take profits in gold and switch into long-term Government bonds at unprecedentedly high yields. How high the yields? Long-term Governments (after their long decline) are already yielding a dramatic 8.5%. If the Fed has to fight a massive wave of expatriated dollars that are "coming home," long-term Governments could go to 9.5%, 10%, who knows! We will just have to wait and see.


Note on this ratio-scaled chart that gold looks quite strong and that the main upward thrust (i.e., the bull market) continues intact. The upper channel line is now at 200 and if gold remains in its primary bull trend this upper trendline will be contacted in due time.
LONDON GOLD ($)
200
190
180
170
160
150
140
130
120
110
1976
1977
1978

GOLD: In the last Letter I stated that I thought gold was in the process of forming a bottom. Touching 171, I added, would be a bullish signal for gold. On May 8 gold (second London fix) gold rallied to $72.20. By May 5 gold hit 175.30. But what was UNUSUAL about the action was that gold was inching up in the face of the big stock market rally. This is something it has not done all year.

I am including my semi-logarithmic (ratio scale) chart of gold. A ratio-scaled chart shows the "thrust" of the price movement (since the chart deals in percentages), and in my opinion the upward thrust of gold is still very much intact. I have drawn in new trendlines, with the bottom trendline (starting in 1976) running parallel to the top trendline.

If gold holds above its secondary rising trendline at about 168 the pattern will continue to be bullish. Further base-building may be necessary here, however, and I would not be concerned if gold backed off a bit, particularly if it can hold above 170.

The chart at the bottom of the page shows gold and the three moving averages I run on the metal. The 4-week MA is now at 172, and gold is holding above this figure. The 13-week MA is now at 178. Thus the first bullish target for gold would be to close above 178 and then hold above that figure. If that happens, I would think that gold would be ready to attempt another assault on the 190 peak of 1978. At the bottom of the chart is the 50-week MA or primary trend line of gold. This long-term MA stands at 161, and it represents the low point at which I would think massive support (buying) would come in, regardless of any reaction or spate of weakness in gold.

RISK-REWARD: Sometimes I wish that I was writing these reports for only millionaires. The reason is that wealthy men think differently than most people. When presented with a new proposition, whether it is a business participation, a real estate concept, a tax shelter or a move into the stock market, the wealthy man always thinks in terms of one concept–what is the risk-reward? Put it this way: there are (at any given time) a dozen different ways of spending your money. The question is–do any of them make sense from a risk-reward standpoint?

By dealing with the market for over three decades, I have learned to think the risk-reward way. Behind this concept, implicitly, is the idea of patience. You must have patience in the investment business or you will be "taken," you will literally "lose your shirt." Patience means that you wait for the right looking proposition. You know that the market is always there, and you can afford to pick and choose according to your own methods and procedures.